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C O N F I D E N T I A L SECTION 01 OF 03 CAIRO 002726

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SUBJECT: ECONOMIC REFORMS SHOWING RESULTS, BUT SLOWING

Classified by DCM Stuart Jones for reasons 1.4 (b) and (d).

¶1. (U) Summary and introduction: Since 2004, the Nazif government has cut tariffs and tax rates, fixed the current exchange system and eliminated the black market, rationalized fiscal cash managements with its Single Treasury Account, partially privatized and recapitalized the banking sector, and sold off several major state-owned enterprises. These changes generated confidence and set the state for an economic revival. Business is now growing, foreign direct investment (FDI) rising and domestic consumption rates up. Growth is expected to be 8 percent in 2007/08, up from 7.5 percent this past year. FDI is expected to reach \$11 billion by year-end. Non-oil exports were up 42 percent in June 2007 over last year.

¶2. (U) While the big picture story is a positive one, a number of challenges remain. The biggest may be ensuring that reforms are maintained long enough for growth to reach a broader section of society. After several years of slow growth, up to 2004, in which the national poverty rate actually rose slightly, there is a pent-up demand for economic benefits.

¶3. (SBU) On the macroeconomic side, the GOE must reduce the budget deficit, which was about 7.5 percent of GDP in 2006/07. Inflation can be expected in a time growth and rising commodity prices, but at 12 percent in the first quarter of 2007, increases in food, housing and transportation have hit hard. Some ongoing reforms, such as trade facilitation, deregulation, and privatization have run into political opposition. Difficulties faced by small and medium-sized enterprises (SMEs) are a real obstacle to making high growth sustainable. And, most significantly, the average Egyptian is not yet feeling the benefits of growth. The next round of reforms, to include reducing subsidies, and improving services in health, education, skills, housing and transportation, are complex and have the potential to cause social upheaval. Implementation will require significant political will. End summary

¶4. (U) In a rare August 24 press interview, Egyptian President Hosni Mubarak supported Egypt's economic reform program, speaking in detail about the program's accomplishments and future challenges. Mubarak's interview followed an earlier TV appearance by Prime Minister Nazif, in which he addressed a number of controversies including villages that lack clean drinking water, poverty alleviation and GOE land sales. This was the first time in recent memory that Mubarak has spoken publicly, and positively, and economic reform. Most notably, he spoke in some detail about the importance of the recently announced plan to privatize Banque du Caire, which has provoked a loud and angry response in Parliament and from the public.

¶5. (U) In his remarks, Mubarak said the reforms are intended to raise living standards. He cited job creation, wage

increases, new factories and housing, and infrastructure renewal, in addition to the overall positive impact of the macroeconomic reforms. Cautioning that the results will take time, Mubarak promised additional resources for lower income groups. On inflation and wages, he cited recent government salary increases but said increases are not a "magical solution" to inflation.

¶6. (U) In Nazif's August 12 TV appearance, he talked about the gap between a booming business sector and continued economic hardship and dissatisfaction for many Egyptians. Nazif spoke about the need for continued banking sector reform, pointing to the success of the Bank of Alexandria sale and resulting improvements in bank services and management. Nazif also outlined challenges facing the GOE. He explained that as the economy shifts from a command to a market economy, there is an unavoidable lag between business growth and a positive impact on lower income groups. This, he said, is exacerbated by population growth, Egypt's "difficult" geographical location and the international political climate. He underlined, however, that the GOE would address the social dimension of economic change.

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Some reforms not so hard  
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¶7. (SBU) Both Mubarak and Nazif addressed the benefits of ongoing financial sector reforms, the gap between the rich and the poor, and continuing inflation -- areas in which the GOE remains politically vulnerable. In other sectors, there is a consensus within the government, and the public, for reform and new investment, including in transportation, health care, education and housing. Everyone understands that these improvements are long overdue, so reforms,

CAIRO 00002726 002 OF 003

although difficult, appears to be moving ahead.

¶8. (SBU) For example, Egyptians agree on the need for comprehensive education reform. The quality of primary and secondary education has deteriorated in recent decades and graduates do not have the skills they need to compete in the labor market. Students pay teachers for private tutoring to make up for low teacher salaries and poor quality classroom instruction, and there are constant calls for school repair and construction. This consensus allowed for relatively easy passage of a first round of reform legislation in June, when the parliament created a new system for hiring, training and promoting teachers. (NOTE: USAID played an essential role in guiding the reform legislation.) The situation is similar in the case of health care, where Egyptians are desperate to see improved services and where the GOE sees itself in a "hearts and minds" competition for service provision with the Muslim Brotherhood.

¶9. (SBU) The Ministry of Transportation has an ambitious plan to renew dilapidated transport infrastructure and improve safety. Minister of Transport Mohamed Mansour hopes to reduce the role of road transport in hauling Egypt's good, in favor of increase shipping by rail and river transport. Mansour is receiving substantial budget support for his program. These long overdue infrastructure investments will support economic growth and meet the public's demands for improved services. The challenge on the reform side is to ensure that the government agencies that run these services improve their maintenance and repair record; reforms to increase cost recovery are essential but will be difficult.

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While others are harder  
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¶10. (SBU) While progress is made on some fronts, change has slowed elsewhere. Additional efforts are still needed in the financial sector, on insurance, microfinance regulation, and the development of security and mortgage markets. Although budget transparency has improved, security and defense

spending remains off-budget. Press reports of alleged wheat shortages stirred fears of bread shortages, which the opposition claims the GOE will use as a pretext to reduce subsidies. The GOE has assured the public that food subsidies will continue, though the GOE would like to target them more effectively.

¶11. (SBU) The GOE is making progress on energy subsidies. On August 14, it announced plans to phase out fuel subsidies over the next three years for the largest corporate beneficiaries (ie., cement, steel and petrochemical companies), to increase natural gas prices, and to move toward the economic pricing of electricity. Energy subsidies are estimated to cost nearly LE 40 billion (\$7b) per year, or about five percent of GDP, and benefit mainly heavy industry.

¶12. (U) Privatizations continue, but the pace has slowed a bit from 2005/06 to 2006/07, with sales volume dropping from LE 14.6 billion (\$2.5b) to LE 13.6 billion (\$2.3b) during that period. The GOE recently cancelled some sales of pharmaceutical, chemical and fertilizer companies after opposition parties and unions complained that the companies were too important to the economic security of the country to be sold. While results vary, overall results of privatization are positive, as profits are rising, management improving and labor resistance minimal.

¶13. (SBU) Other sectors where reform is proving tougher than expected include trade facilitation and business deregulation. Although progress has been made, establishing a company in Egypt remains difficult and most small proprietors much prefer to remain unofficial. This vast group of informal sector businesses do not have access to bank financing, and many plan to stay that way rather than subject themselves to the corruption and harassment that come with dealing with government licensing and inspections. The bloated public sector itself, and the need to reduce employment rolls while improving public services, has not even been publicly discussed. Civil service reform will need to go hand in hand with training that can provide workers with skills needed by Egyptian companies. Such programs have been implemented elsewhere, but they require coordination and vision. Other areas in need of reform include agriculture and water policies, and corporate governance.

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Comment  
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¶14. (C) Why does the prospect for future reform not look more rosy, given the eye-catching measures that the GOE has

CAIRO 00002726 003 OF 003

taken in recent years? This is primarily because the next round of reforms will be harder, more controversial, and inter-related. They will require tough decisions, with potential political fall-out. Most reforms, including of macroeconomic policies, and changes to customs and taxes, have been led by Minister of Finance Yousef Boutros-Ghali. Other ministers must now step up and make some tough political decisions, particularly in the case of Minister of Trade and Industry Rachid, but also in Agriculture, Irrigation, Housing and others.

¶15. (C) It is worth noting that the failure of the FTA is seen by some in the business community as having derailed, at least temporarily, some of those changes. AmCham's executive director recently argued that the FTA provided a framework and an impetus for many of the changes that need to be made. Without the momentum of the negotiations, these efforts lost their focus. Those who were pushing the FTA within the government were humiliated by the setback, within political circles, and lost a certain degree of their credibility and influence over their opponents within the system. They are clawing their way back, and growth figures certainly help them to make their case that reform for its own sake is worth

the effort, but this will be a long struggle.

¶16. (C) As reforms become more difficult, support from the top is essential to persuading Egyptians to accept the changes, and to have patience rather than back-pedaling. In a recent conversation with the Ambassador, leading reformer and Minister of Investment Mahmoud Mohieddin admitted that the GOE has not done a good job of selling, or even explaining, the reform program to the public. If Mubarak's comments, his first about economic reform in recent memory, are an indication of a trend, this is good news for the reformers, and the change may have come just in time.

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